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CAPITAL MARKET LIBERALIZATION IN JAPAN

Summary

Japan's financial system has made an important contribution to that country's high level of investment and rapid economic growth. Between 1952 and 1973 business investment in Japan increased by an average annual real rate of 14.4 percent. One of the key factors in this expansion was the system's ability to channel household savings into productive domestic investment at a low cost to borrowers.

The economic events of the 1970s led to substantial capital market liberalization in Japan, and the pace accelerated after the November 1983 U.S.-Japan agreement on financial reform. During the past two years, Tokyo has liberalized its foreign exchange market and introduced three new yen instruments to be traded -- Euroyen bonds, bankers' acceptances and bond futures. The major changes in Japan's financial system have helped make Tokyo an important international financial center and, it is hoped, will lead to increased international use of the yen. They have also been instrumental in turning Japan, with its high saving rate, into the largest creditor nation in the world.

The Evolution of Japan's Financial System

Despite Japan's emergence as a major economic power, its financial system remained tightly regulated and isolated from the rest of the world until the first oil crisis in 1973. A high degree of specialization among financial institutions limited access to markets. As in the United States, banks were

excluded from the securities market and prohibited from underwriting or dealing in securities. The commercial banking business was further separated into city (nationwide) and regional banks, long-term credit banks and trust banks. The management of trust funds was restricted to the eight trust banks and 21 domestic insurance companies. City and regional banks, which specialized in short-term lending, raised funds from deposits and by borrowing from both the interbank market and the Bank of Japan. Long-term credit banks did not accept deposits but were allowed to issue debentures to raise funds.

The system concentrated an enormous amount of economic power in the nation's central bank -- the Bank of Japan -- and the Ministry of Finance. The BOJ set interest rate ceilings for all major types of deposits, and the prime rate and other important lending rates were tied to its official discount rate. Since interest rates were set below market-clearing levels, there was usually excess demand for bank credit. Furthermore, setting the discount rate below equilibrium levels gave the central bank power to ration credit. The framework of specialization among financial institutions helped enforce interest rate controls by limiting substitution among assets and preventing arbitrage among markets.

Capital controls on international transactions and foreign exchange helped to preserve Japan's financial structure by insulating it from foreign influences. Under the Foreign Exchange Control Law of 1949, all foreign exchange and capital transactions were subject to government control unless specifically exempted. The purpose of the law was to prevent Japanese companies from circumventing credit restraints by borrowing abroad and to prohibit the foreign takeover of domestic companies. It was also intended to help prevent balance of payments problems that would force a devaluation of the yen.

Additionally, restrictions on the issuance of yen-denominated bonds by foreign firms in Japan slowed the development of the domestic securities market. Short-term capital inflows through banks were subject to yen conversion limits, while foreign banks were not permitted to borrow funds from the call money market. These types of restrictions made the overseas role of Japanese financial institutions and the activities of foreign institutions in Japan relatively minor.

Although the numerous regulations introduced inefficiencies into financial markets, the system was well-suited to Japan's need for cheap capital to increase productive capacity in the years following the war. Much of the burden was borne by the household sector, which earned a lower return on its savings than would have been the case in a less regulated environment. But this loss was largely offset by the benefits that accrued from the 10 percent-plus annual real growth of national income during the 1960s.

Financial Liberalization in the 1970s

Economic events in the 1970s led to forces for change in the rigid financial structure. The two major oil price increases and the breakdown of the fixed exchange rate system resulted in higher rates of inflation, slower

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economic growth and volatile changes in the value of the yen. With fixed nominal interest rates, inflation produced abrupt changes in real returns. Although for most of the decade inflation was lower in Japan than in most other advanced countries, it did make savers aware of the hazards of low-yielding deposits and led to pressure for reform.

Slower growth in the years after the first oil shock led to a decline in private investment's share of the gross national product from 33.9 percent in 1970 to 26 percent in 1975. As corporations frequently had excess funds in the slower-growth environment, they, too, became more sensitive to the rate of return on financial investments. With reduced net borrowing by the corporate sector, the government began to play a larger role in supporting domestic demand and absorbing the high level of household saving. Consequently, although policymakers had previously adhered closely to balanced budgets, the government began to issue large amounts of bonds. The increase in government debt, which rose from 6 percent of GNP in FY 1972 to 29.3 percent in FY 1980 (see Table 1), had a major impact on Japan's financial system.

The impact of the major changes that occurred during the 1970s on banking, money markets and international capital flows is discussed below.

The Banking Sector - The Ministry of Finance initially sold government bonds with a maturity of 10 years at below-market interest rates to a syndicate made up of major commercial banks and securities dealers. The syndicate was allowed to resell newly issued bonds after a waiting period of one year. As the volume of government bond issues rose, however, banks became increasingly reluctant to accept them for several reasons. Given the increasing uncertainty over interest rates, the risk of capital losses on sales of bonds in the secondary market was great. In addition, the increasing share of government bonds in the banks' portfolios from 2.2 percent in 1975 to 7.8 percent in 1978 lowered profits. Furthermore, the expanded holdings of long-term government bonds did not match the banks' short-term deposit liabilities.

To make these issues more attractive, the government revised certain issuing and trading practices. In 1977 it instituted five-year discount bonds and the following year began issuing bonds with maturities of two to four years at public auctions, allowing investors to purchase these instruments directly at market terms. In 1981 the time period required for banks to hold new issues of bonds before selling them in the secondary market was reduced to 100 days. As a result of these changes, banks ceased to be net buyers of government bonds and their share of central government debt fell from 29.5 percent in 1979 to 16.2 percent in 1982.

The Revised Banking Law of 1981 allowed some banks to deal in government securities with the general public. Although it was intended to facilitate the issue of government bonds, the law represented a significant blurring of the traditional separation of commercial banking and the securities business. It promoted further expansion of the secondary bond market and strengthened the links between primary and secondary markets.

With the introduction of financial instruments with market-determined interest rates in the late 1970s, the funding of city banks, which depended entirely on fixed-rate deposits, deteriorated. To help them compete, banks

were permitted in 1979 to issue their own free-market instrument, negotiable certificates of deposit. Furthermore, restrictions on participation in the gensaki market (which consists of the resale or repurchase of bonds at a fixed price after a fixed period) were removed in 1979 and secondary trading in CDs began in 1980. One consequences was greater interest rate arbitrage and the integration of interbank markets with unregulated markets outside the banking system.

Short-Term Money Markets - Liberalization of short-term money markets -- the call, bill discount, CD and gensaki markets -- was linked to the conduct of monetary policy. Then as now, the call and bill discount markets operated as interbank markets with six specialized dealers through which transactions had to be placed. The gensaki market was open to all financial institutions.

In the 1960s and early 1970s, the Bank of Japan's monetary policy focused on controlling the volume of bank credit through its loans to city banks and strict control over the interbank market. In addition to posting interest rates in the call market, the bank monitored the allocation of funds and intervened through the six middlemen. The bank also controlled credit through window guidance, which set quotas on the volume of loans by each bank during periods of monetary restraint.

With the emphasis on controlling inflation during the 1970s, the central bank shifted from relying extensively on quantitative limitations toward a more market-oriented policy that centered on controlling the money supply. In any case, the effectiveness of controls on bank loans had declined as the business sector's need for credit contracted following the first oil shock. Monetary policy began to focus on the cost of credit, necessitating greater flexibility in short-term interest rates. Posted rates in the call market were discontinued in 1979 and one-, two- and three-month bills with unregulated interest rates were introduced in the bill discount market. Although "official controls" over the call and bill discount markets were removed, the central bank still maintains close surveillance and intervenes in both markets.

International Capital Flows - Liberalization of the regulations governing international capital flows proceeded at an uneven pace in the 1970s, influenced by changes in the exchange rate. Tokyo responded to both increases and declines in the yen's value by generally reducing barriers in order to induce an offsetting capital flow. In other words, it tended to lower restrictions on capital inflows when the yen depreciated and on capital outflows when it appreciated.

To encourage capital inflows in the period immediately following the first oil crisis, for example, Tokyo liberalized the rules governing inward investments in various Japanese industries, facilitated the issuance of bonds abroad by residents, and raised the ceiling on loans from overseas. Simultaneously, the government took steps to curb the outflow of capital, temporarily halting foreign bond issues in Japan, limiting financial institutions' foreign exchange holdings and restricting overseas lending by Japanese banks.

When the yen appreciated during the 1977-78 period, Tokyo changed course. It eased restrictions on purchases of foreign bonds by Japanese, granted foreign exchange banks greater freedom to lend abroad, and eliminated

the approval requirement for direct overseas investment. The fall in the yen's value after the second oil price hike, however, brought another policy shift, this one in the direction of facilitating an inflow of capital. To cite just one example, starting in 1979, nonresidents were permitted to participate in the CD and gensaki markets, a significant step that increased the integration of Japan's short-term financial markets with those abroad.

These changes led to a more open system, as a glance at the large increase in capital flows between Japan and the rest of the world (see Table 2) demonstrates. By 1980 the government was ready to acknowledge formally its basic policy switch on the movement of capital into and out of Japan. The Foreign Exchange and Foreign Trade Control Law of that year established the principle that all international financial transactions are free of controls unless otherwise specified. The new law widened the scope for foreign portfolio investment in Japan and gave domestic companies greater freedom to borrow abroad. The impact of this law is illustrated by the tripling of foreign purchases of Japanese securities between 1979 and 1981.

The link between changes in the exchange rate and liberalization efforts was broken in the 1980s. Despite a weakening yen during most of 1981 and 1982, Tokyo continued to open up its capital markets by relaxing limits on syndicated loans arranged by Japanese banks and easing the restrictions on bond issues in foreign markets by subsidiaries of Japanese banks.

These changes in Japan's financial system had a major impact on the pattern of corporate finance. During the 1960s and much of the 1970s, firms relied heavily on bank loans rather than on direct financing through the bond and equities markets. There were several reasons for this. First, investors did not view stocks and bonds as safe assets due to the undeveloped state of the Japanese securities market. A stable market in corporate bonds requires the existence of a developed market in risk-free government securities to act as a reference against which to evaluate corporate bonds. Such a market did not exist in Japan due to the small amount of government bonds outstanding prior to 1975 and the limits on their resale by syndicate members. Moreover, there were restrictions on foreign issues of securities by Japanese companies and on nonresident purchases of Japanese equities. The development of the government bond market and the deregulation of the securities market, however, have enabled corporations to broaden their use of direct financing.

The Yen-Dollar Accord

Throughout the 1970s, financial liberalization proceeded steadily but deliberately. While financial institutions pressed for greater deregulation, Tokyo carefully orchestrated the changes to avoid disrupting financial markets that were dependent on the structure of regulation and to maintain control of monetary policy. Few new financial instruments, with the notable exception of the gensaki market, were allowed to develop spontaneously.

In 1983 Japan came under increasing international pressure to accelerate the pace of liberalization of its financial markets. Part of this pressure was based on the ideological conviction that free financial markets are superior and that regulations reduce efficiency in allocating capital. Analogous to the case for free trade of goods, economists generally agree that both global and national welfare is best served by unrestricted capital flows.

U.S. pressure for reform was also based on the belief that Japanese financial regulations had driven down the value of the yen by making it an unattractive currency. More open capital markets, Washington believed, would increase international use of the yen, raising its value and reducing trade problems. Another important motive was increased access to Japanese capital markets for foreign financial firms, which complained that regulations hindered them from playing a larger role in financial transactions in which they were competitive. Greater access would also enable American institutions to tap Japan's large supply of savings. At the same time, though, these capital outflows would tend to weaken the yen.

The result was the November 10, 1983 agreement between then-Treasury Secretary Donald Regan and Minister of Finance Noboru Takeshita covering specific measures to liberalize Japan's financial markets. Beryl Sprinkel, at that time under secretary of the Treasury, hailed the pact as "an important milestone in [Tokyo's] philosophical approach to financial and capital markets" that "created the basis for fundamental change." A yen-dollar working group was established to monitor progress in implementing the measures and to pursue additional steps.

The measures taken by Tokyo as a result of the yen-dollar accord can be divided into four categories: the liberalization of Japanese barriers against the inflow and outflow of capital; the internationalization of the yen; more favorable treatment of foreign financial institutions in Japan; and deregulation of domestic Japanese capital markets. The changes Japan has initiated in each of these categories during the past two years are discussed below.

Liberalization of Barriers to Capital Flows - One of the most important measures was the relaxation of rules covering samurai bonds (yen-denominated bonds issued in Japan by nonresidents), which were first introduced in 1979. In June 1984 the Ministry of Finance lowered the credit rating required for issuers, reduced the waiting period between issues and raised the permitted size of each issue. These changes led to a sharp increase in the volume of samurai bonds issued in 1985 to slightly more than Y1.1 trillion ($5.6 billion at Y200=$1.00). In addition, there have been five issues of shogun bonds (dollar-denominated bonds issued in Japan by nonresidents) since that instrument was approved by Tokyo last April.

In the 1982-83 period, the Ministry of Finance set quantitative limits on overseas yen lending by Japanese banks out of concern over the low value of the yen and the international debt crisis. In 1984, however, restrictions on the overall amount of lending and the accompanying country limits were abolished, leading to a substantial rise in foreign yen loans.

Another significant reform was the end to the ban on the sale of foreign commercial paper and CDs in April 1984. This step, originally planned for 1982, had been delayed to avoid depressing the yen through large capital outflows. In addition, regulations on financial accounts held by residents abroad were eased, a move that will contribute to the efficient use of Japan's savings surplus.

In addition to the above measures, which liberalized capital outflows, the Diet in May 1984 abolished the "designated company" system governing

foreign direct investment in Japan. Under this system, nonresidents were prohibited from acquiring more than a specified percentage of certain designated companies (11 in all). The same law liberalized real estate purchases for foreigners in Japan. Moreover, restrictions on short-term Euroyen loans to Japanese residents were lifted in June 1984, producing a steady increase in the volume of such lending.

In response to the U.S. proposal that Tokyo finance its government deficit overseas rather than in Japan, legislation authorizing overseas bond issues was passed in 1984; however, the new borrowing authority has yet to be used. Overseas borrowing by government-affiliated agencies, though, has contributed to efforts to raise the value of the yen. The Japan Development Bank, for example, issued $100 million of bonds in New York on two occasions in 1984 and another $200 billion in November 1985.

Internationalization of the Yen - As mentioned above, one of Washington's goals was to increase the value of the yen by promoting its use as a transaction currency in trade, an investment currency by nonresidents and a reserve currency by foreign governments. In the past Japanese monetary authorities, like those in other countries, were concerned that extensive foreign holdings of their currency would reduce the government's control over the money supply and increase the variability of the exchange rate. But capital flows do not affect a country's monetary base unless the central bank intervenes in the foreign exchange market. And, in fact, the yen has undergone wide swings in its exchange value despite the fact that it has been less widely used internationally than other major currencies.

Although the share of the yen in global official foreign exchange reserves doubled from 2 percent in 1976 to 5.2 percent in 1984, it is still small relative to the dollar's 65.1 percent share and the West German mark's 12 percent share. Given the size of Japan's economy, the percent of its trade denominated in yen in surprisingly small. Only 3 percent of Japan's imports are valued in yen, while about 40 percent of the foreign purchases made by Germany, the United Kingdom and France are denominated in local currencies. One reason for the low use of the yen is that a high percentage of Japan's imports are raw materials, most of which are priced in dollars worldwide. Moreover, the absence of a bankers' acceptance market in Japan until recently and the quantitative controls that formerly restricted bank lending encouraged importers to obtain trade credits abroad.

One step toward wider use of the yen was the removal of the "real demand rule" in April 1984 that limited foreign exchange transactions to those that covered specific real transactions. This change has led to a large increase in foreign currency operations since purely speculative transactions are now permitted. A market in bankers' acceptances, which are issued by exporters and importers in exchange for cash to underwrite trade transactions, opened in June 1985. This market should encourage banks to link short-term loan rates to the market, bringing free-market forces to short-term lending. But increased demand for yen, a major goal in the establishment of this market, may not be fulfilled since traders can reverse their yen position in the foreign exchange market. Washington hopes, though, that increased use of the yen as a unit of account will increase the demand for yen as an asset. The failure of the bankers' acceptances market to live up to expectations thus far is attributed in part by some observers to complex rules governing the market.

Japan's restrictions on the Euroyen market, an area of strong bilateral contention, have also been liberalized during the past two years. Domestic and foreign banks can now issue and trade short-term negotiable Euroyen CDs outside of Japan; however, issuance of this instrument has been lagging because the maximum allowed maturity of six months is too short. Since April 1984, moreover, the Finance Ministry has permitted some Japanese firms to issue yen-denominated bonds in the Euromarket, with about 90 firms eligible initially. Although securities firms had pushed for letting some 700 domestic firms issue Euroyen bonds, a further lowering of asset and balance sheet requirements in April 1985 increased the number of eligible firms to only 145. The Finance Ministry also requires that firms wait 180 days before repatriating funds raised in the Euroyen market. Since restrictions on domestic borrowers become irrelevant as curbs on using the Euroyen bond markets are lifted, Tokyo has been reluctant to make wholesale liberalizations for fear of disrupting the domestic bond market.

The United States also singled out Tokyo's initial 20 percent withholding tax on Euroyen bonds issued by Japanese firms as a serious disincentive to expansion of this market, since the tax made the bonds unattractive and blunted the effectiveness of the reforms. Given its fiscal situation, the Nakasone administration was not anxious to reduce government revenues, but on April 1, 1985 Japan followed the United States, Germany and France in eliminating the tax for nonresidents. This action contributed to the impressive total value of Y1.4 trillion ($7 billion) in Euroyen bonds during 1985, the first full year after liberalization. The 63 Euroyen bonds issued accounted for 5.2 percent by value of all Eurobond issues in 1985, compared to 1.5 percent in 1984.

Since December 1984 Tokyo has allowed non-Japanese corporations to issue yen bonds in the Euromarket. Prior to that time the issuance of such bonds was limited to foreign governments and international financial institutions. Tokyo imposes no restrictions on the size and number of Euroyen bond issues by non-residents and allows any bank or securities firm to serve as lead manager. Foreign firms accounted for all but seven of the 63 Euroyen bonds issued last year, as Japanese companies found it cheaper to issue Eurodollar bonds. Innovations, such as zero-coupon, floating-rate and dual-currency bonds (allowed since June 1985), helped the volume of the Euroyen bonds to exceed the volume of samurai issues in 1985.

Treatment of Foreign Financial Institutions in Japan - Foreign banks have been authorized to trade in government bonds in the secondary market and to join the underwriting syndicate that purchases newly issued government bonds since April 1984. Swap limits -- restrictions on the amount of foreign currency that each foreign and Japanese bank could convert into yen for lending purposes -- were abolished two months later. Ironically, many foreign banks in Japan have been hurt by deregulation, which has denied them some of the special privileges they enjoyed in the past.

A major issue has been the entry of foreign banks into the business of managing trust and pension funds in Japan. This is likely to become an increasingly lucrative business, as corporate pension funds are expected to increase from $100 billion in 1984 to $300 billion in 1995 due to the rapid aging of Japan's population. The MOF has thus far approved the applications of seven foreign banks to participate in trust banking operations; two additional banks are expected to be approved.

On February 1, Merrill Lynch & Co. became the first foreign brokerage house to execute trades on the Tokyo Stock Exchange, the world's second-largest equity market. Of the 10-seat increase in the TSE's membership last December, six were assigned to foreign financial firms, including Morgan Stanley & Co. and Goldman Sachs & Co. as well as Merrill Lynch. The admission of foreign firms should facilitate the purchase of Japanese equities by nonresidents and increase the trading of foreign stocks in Japan.

Liberalization of Domestic Capital Markets - Negotiations in this area have focused on reducing interest rate controls to give free-market forces more of a role in determining the flow of financial resources. Controls on large time deposits of Y1 billion or more ($5 million) were removed in October 1985, and those on deposits of Y500 million ($2.5 million) will be lifted this spring. The MOF hopes to lift controls on deposits of Y100 million ($500,000) and above by the spring of 1987 -- a major landmark in the deregulation of financial markets that should lead to across-the-board relaxation of interest rate controls.

There has also been steady deregulation of the CD market. The ceiling on the amount banks can offer has been raised and the minimum denomination, which was lowered from Y500 million ($2.5 million) in 1983 to Y100 million ($500,000) in April 1985, is likely to be reduced to Y50 million ($250,000) next year. In June 1985, moreover, securities firms began trading these instruments for the first time. This move, which further lowers the barriers separating the banking and securities industries, should help expand the market beyond the current Y500 billion ($2.5 billion) level.

A new instrument, money market certificates, was introduced last March, with a rate of return pegged 0.75 percentage point below the CD rate, which is market-determined. In the spring of 1987, the minimum denomination is scheduled to drop to Y20 million ($100,000) and the maximum maturity of both CDs and MMCs is expected to be increased to one year. The deregulation of interest rates on deposits and the lowering of the minimum denomination on MMCs planned through the spring of 1987 are expected to reduce bank income as much as 37 percent.

A short-term (maturity of less than a year) bond market began last April. In June the government increased the number of banks allowed to deal in outstanding government bonds from 37 to 87. All maturities, except new issues, may be freely traded. A market in bond futures, which opened on October 19, 1985, got off to a rocky start. While it was designed to help dealers hedge their risks on new issues of government bonds, the rise in interest rates on October 25 led to a flood of selling and several securities firms lost millions of dollars.

Outlook

Japan's financial system has changed significantly since the early 1970s. Financial activities have been substantially decontrolled and new markets and instruments have been created. Liberalization of rules covering the activities of Japanese firms overseas and foreign firms in Japan has increased the internationalization of the system. The narrowing of the differential between the London Euroyen interest rate and the gensaki rate in Japan demonstrates that Japan is open to international flows of short-term capital.

The amount of new bond issues in FY 1984 was Y43.6 trillion ($218 billion), compared to Y7.3 trillion ($36.5 billion) in FY 1971. The public sector's share increased from 32 percent to 54 percent during that period. The outstanding balance in short-term money markets also increased from Y2.4 trillion ($12 billion) at the end of 1970 to Y25.8 trillion ($129 billion) at the end of 1984. The CD market has overtaken the bill discount market as the largest short-term money market.

While the developments of the stock market has been uneven, the sales value increased from Y12 trillion ($60 billion) in 1970 to Y831 trillion ($4.2 trillion) in 1984. Foreign purchases of Japanese stocks, which have fluctuated sharply as well, rose from $1 billion in 1970 to $35.9 billion in 1984.

These changes should lead to increased use of the yen in trade and as an investment and reserve currency. The internationalization of the yen, though, cannot be achieved unilaterally since it depends on the decisions of traders, investors and foreign governments; therefore, it is likely to increase gradually.

Capital market liberalization has also made Tokyo an important financial center. In terms of gross bond issues, Japan is the second largest (excluding the Euromarket). It is the third-largest market for foreign bond issues, with a share that has risen from 0.3 percent in 1976 to over 13 percent in 1982. The market value of stocks listed on the Tokyo Stock Exchange is more than double the London Stock Exchange, although there are fewer foreign companies listed. Some observers believe, however, that Japan's high withholding tax and its tax on equity transactions will limit Tokyo's role as an international financial center.

The effect of these changes on the yen's value -- a major motive for U.S. pressure for liberalization in 1984 -- is less clear. Many of the reforms encourage the outflow of capital, which weakens the yen, but in general, capital market liberalization has not had a major impact on the yen's value. It is clear that, given Japan's low interest rates, measures that free international capital flows while interest rates are still controlled will encourage capital outflows. Complete liberalization, though, should raise Japanese interest rates to world levels and remove the incentive for outward flows.

The impact of liberalization on the volatility of changes in the yen's value is uncertain as well. Some expect it to increase volatility, as the absence of capital controls leads to larger flows. But capital controls have led to thin markets susceptible to sharp fluctuations, and their removal should result in a deeper, more stable market.

Despite substantial progress, financial markets in Japan are still less developed and more restricted than in the United States, and Tokyo remains under pressure to continue the liberalization process. Last December Assistant Treasury Secretary David Mulford criticized Tokyo for maintaining controls on which companies may issue Euroyen bonds. Washington wants Tokyo to replace its current system, which is based on various financial criteria, with the type of rating system used by other countries. Mr. Mulford also complained about the lack of an active and liquid secondary market for Euroyen bonds. This situation is largely a result of the common practice of channeling the bonds

to Japan. The U.S. official also called for reduced restrictions on the trading of Japanese government bonds, including additional licenses for foreign banks.

A major issue is the continued decontrol of interest rates, including those on small deposits. Most interest rates paid on bank and postal savings deposits are fixed at low levels. This impairs efficiency in terms of the allocation of both capital and equity, as wealthy investors receive higher returns. Prior to the lifting of controls on small deposits, which is expected to begin in the spring of 1987, the Finance Ministry plans structural changes, such as improving deposit insurance, to increase the stability of the market for small savers. It will also have to tackle reform of the postal savings system, which holds more than Y10 trillion ($50 billion) in deposits and absorbs 32 percent of all personal savings in Japan. Banks complain that they cannot compete since postal savings rates are set higher than bank deposit rates and the system is free from taxes, deposit insurance and reserve requirements.

The separation of banking and the securities business is likely to continue to erode in the future. The significant expansion of bond offerings in international capital markets, sometimes termed the "securitization" of financial markets, has increased banks' incentive to enter the securities business. Tokyo recently allowed the securities subsidiaries of foreign banks to open branches in Japan, a prerogative still denied Japanese banks. If a foreign subsidiary of a Japanese bank were to gain the same right, that would end Japan's strict separation of investment and commercial banking.

The United States has encouraged Japan to develop a market in short-term securities analogous to the U.S. Treasury bill market. (Until now, almost all short-term notes have been sold to the Bank of Japan.) The development of such a market would help smooth out the debt-rescheduling process by broadening the maturity structure of government debt. Furthermore, it would accelerate the decontrol of interest rates, although Tokyo is reluctant to sacrifice the low-cost deficit financing that the present system allows. A short-term government bond market would also enable the central bank to replace current monetary policies with open-market operations.

The Finance Ministry's plans for such a market are said to be progressing and it expects to make its first offering of three- and six-month bills in the near future. Washington, however, is critical of several aspects of the program, including a 16 percent withholding tax, which will make the instrument less attractive to foreign investors, and the plan to limit the market to corporate investors.

One measure likely to increase the international use of the yen is the establishment of an offshore banking facility in Tokyo, an idea recommended by an advisory panel last September and approved by the cabinet last week. Such an establishment permits banks to operate without having to meet the regulatory and tax requirements of the country in which the facility is physically located. The Bank of Japan is thought to favor limiting the facility to commercial banking, as in New York, in order to minimize leakage from the domestic market that would complicate the conduct of monetary policy. Securities firms, of course, want the Tokyo facility to include investment banking as well, as in

London. In addition to increasing the use of the yen, offshore banking would help Tokyo compete with Hong Kong and Singapore as a world financial center. Observers say that offshore banking could be launched as early as this November.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japanese Government Debt

(in trillions of yen)

Fiscal Year	Amount Issued	Amount Outstanding	Amount Outstanding as a Share of GNP
1972	Y1.95	Y5.82	6.0%
1973	1.77	7.55	6.4
1974	2.16	9.66	6.9
1975	5.28	14.97	9.8
1976	7.20	22.08	13.0
1977	9.56	31.90	16.9
1978	10.67	42.62	20.6
1979	13.47	56.25	25.3
1980	14.17	70.51	29.3
1981	12.90	82.27	32.3
1982	14.04	86.48	36.1
1983	13.49	109.70	39.4
1984	12.86	121.69	41.0

Source: Ministry of Finance

Table 2: Japan's Capital Account

(in billions of dollars)

Year	Net Long-Term Capital	Assets (Outflows)	Liabilities (Inflows)
1970	-$1.6	$2.0	$0.4
1971	-1.1	2.2	1.1
1972	-4.5	5.0	0.5
1973	-9.8	8.5	-1.3
1974	-3.9	4.1	0.2
1975	-0.3	3.4	3.1
1976	-1.0	4.6	3.6
1977	-3.2	5.2	2.1
1978	-12.4	14.9	2.5
1979	-12.6	16.3	3.7
1980	2.4	10.8	13.2
1981	-6.4	22.8	16.4
1982	-15.0	27.4	12.4
1983	-17.7	32.5	14.8
1984	-49.7	56.8	7.1

Source: Bank of Japan